ILLINOIS COMMERCE COMMISSION

DOCKET NO. 99-

EXHIBITS SPONSORED BY ROBERT A. SCHULTZ

APRIL 16, 1999

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ILLINOIS COMMERCE COMMISSION

DOCKET NO. 99-

PREPARED DIRECT TESTIMONY OF

ROBERT A. SCHULTZ

I. INTRODUCTION AND PURPOSE OF TESTIMONY

1. Q. Please state your name, business address and present position.

A. Robert A. Schultz, 500 South 27th Street, Decatur, Illinois 62525. I am Vice President - Finance of Illinois Power Company (“Illinois Power”, “IP” or “Company”).

2. Q. Please summarize your educational background and professional experience.

A. I have a Bachelor’s Degree in Business Administration from Kalamazoo College and a Master’s Degree in Business Administration from Harvard Business School. I joined Illinois Power as Director - Planning and Programming in October 1986. I was elected Treasurer in April 1989. I was elected President of Illinova Power Marketing, Inc. in October 1994, and President of Illinova Energy Partners in May 1996. I was elected Vice President - Finance of Illinois Power in February 1998. Prior to joining the Company, I had various assignments over a 23-year period in the United States Navy.

3. Q. What are your duties and responsibilities in your present position?

A. My current duties as Vice President - Finance include responsibility for all treasury, accounting, forecasting, risk management and investor relations functions.

4. Q. In addition to your prepared testimony, IP Exhibit 3.1, are you sponsoring other exhibits?

A. Yes, I am sponsoring the following exhibits, which were prepared under my supervision and direction: IP Exhibit 3.2, entitled Rate of Return on Common Equity Projections; IP Exhibit 3.3, entitled Illinois Power Financial Projections - With WESCO; IP Exhibit 3.4, entitled Illinois Power Financial Projections - No WESCO; IP Exhibit 3.5, entitled Market Prices for High and Low Market Price Scenarios; IP Exhibit 3.6, entitled Projected Earned Rates of Return on Common Equity with Higher and Lower Market Prices; IP Exhibit 3.7, entitled 30-Year U.S. Treasury Bond Yields; IP Exhibit 3.8, entitled Comparison of Key Financial Indicators; and IP Exhibit 3.9, entitled Listing of Assets and Related Liabilities Transferred to Illinova.

5. Q. What is the purpose of your testimony?

A. As required by Section 16-111(g)(vi) of the Public Utilities Act (“Act”), I will present projections of Illinois Power’s earned rate of return on common equity for the years 1999 through 2004, calculated in accordance with Section 16-111(d) of the Act, both with and without the transfer of IP’s fossil generation assets to Illinova Corporation (“Illinova”). These projections show that Illinois Power will not, as a result of the asset transfer, qualify to request an increase in its base rates under Section 16-111(d) during the “mandatory transition period” which extends until January 1, 2005. I will also present a complete set of five-year financial projections for the years 2000-2004 both with and without the asset transfer, including balance sheets, income statements, cash flow statements and key financial ratios. I will discuss the implications of these financial results, which show that Illinois Power’s financial condition will be better with the transfer of the fossil generation assets and the formation of Illinova Power Marketing, Inc. (which I will refer to as “WESCO”) than if these transactions do not occur. I will provide the underlying assumptions that were used in the development of the financial projections, and describe the basis on which key assumptions were developed.

The projected earned rates of return on common equity, projected financial statements, and underlying assumptions which I will present are the same as those included in the Company’s notice of the asset transfer that was filed with the Commission on April 16, 1999.

The financial projections and underlying assumptions which I am presenting are also the basis for the projected financial results for WESCO which Mr. Dreyer is presenting.

II. PROJECTED EARNED RATES OF RETURN ON COMMON EQUITY

6. Q. What is shown on IP Exhibit 3.2?

A. IP Exhibit 3.2 presents Illinois Power's projected earned rate of return on common equity for the years 1999 through 2004, calculated in accordance with Section 16-111(d) of the Act, with the transfer of the Company's fossil generation assets to Illinova and without the transfer.

7. Q. What are the specific transactions modeled in the "with asset transfer" scenario?

A. Illinois Power sells its fossil generating assets to Illinova in exchange for an interest-bearing note. Illinova in turn makes a capital contribution of the transferred assets to WESCO. IP and WESCO enter into a Power Purchase Agreement ("PPA") pursuant to which WESCO supplies electric power and energy to IP. In addition, WESCO assumes responsibility for all operating activities associated with the fossil generating assets. Mr. Dreyer and Messrs. Eimer and Reynolds describe the organization, resources and operations of WESCO in much greater detail.

8. Q. What is the calculation of earned rate of return on common equity specified in Section 16-111(d)?

A. The calculation of earned rate of return on common equity specified in Section 16-111(d) is:

> net income applicable to common stock divided by the average of its beginning and ending balances of common equity using data reported in the electric utility's Form 1

> report to the Federal Energy Regulatory Commission but adjusted to remove the effects of accelerated depreciation or amortization or other transition or mitigation measures implemented by the electric utility pursuant to subsection (g) of this Section [i.e., 16-111(g)] and the effect of any refund paid pursuant to subsection (e) of this Section [i.e., 16-111(e)].

9. Q. For purposes of your calculations of the projected earned rates of return on common equity shown on IP Exhibit 3.2, were any adjustments made as specified in Section 16-111(d)?

A. Yes. In connection with the impairment of Clinton Power Station ("CPS") and the quasi-reorganization which the Company implemented at December 31, 1998, a regulatory asset was recorded based on the amount of CPS costs which the Company anticipates recovering during the period in which transition charges can be collected under the Act. This regulatory asset must be amortized over the period during which transition charges may be recovered. For purposes of the rate of return on common equity calculations on IP Exhibit 3.2, net income applicable to common stock was adjusted to remove the after-tax impact of the annual amortization of the regulatory asset, and the balances of common equity were adjusted to remove the cumulative after-tax impact of the amortization of the regulatory asset. Because the projections did not show that the Company's two-year average earned rate of return on common equity would be high enough to result in refunds pursuant to Section 16-111(e) during this period, no adjustment to the calculation for such refunds was necessary.

10. Q. What assumptions were used in developing the projections of earned rate of return on common equity?

A. The key assumptions used in preparing the financial projections for the asset transfer are set forth on pages 4 - 8 of IP Exhibit 3.3. The key assumptions used in preparing the financial projections with no asset transfer are set forth on pages 4 - 7 of IP Exhibit 3.4. I will describe these assumptions in detail later in my testimony.

11. Q. What market prices for electric power and energy were used in the financial projections?

A. The market prices for electric power and energy that were used in the financial projections are shown in the statements of assumptions in IP Exhibit 3.3 and 3.4. The same market price projections were used in both the "with asset transfer" and "without asset transfer" projections.

12. Q. How were these market price projections developed?

A. The market price projections were developed for the Company by Putnam, Hayes & Bartlett ("PHB"), an economic consulting firm which has been actively involved in electric restructuring and deregulation issues throughout the country as well as in other countries. The PHB projections took into account regional capacity and load projections (including anticipated generation additions) and transmission constraints. The PHB market prices were also used by the Company in developing the write-up of the values of the fossil generating units from depreciated original cost to market value at December 31, 1998 as part of the Company's quasi-reorganization.

13. Q. Did you prepare financial projections using alternative assumptions as to the market prices of electric power and energy over the forecast period?

A. Yes. Under the terms of the PPA, Illinois Power's power supply expense and WESCO's revenues will be sensitive to differences in market prices of power and energy. Therefore, we prepared additional projections using both a "high" market price scenario and a "low" market price scenario. IP Exhibit 3.5 shows the annual market values which were used in the "high" and "low" market price scenarios.

14. Q. Have you prepared projections of the Company's earned rates of return on common equity for the years 1999-2004, calculated in accordance with Section 16-111(d), using the high and low market price values?

A. Yes. IP Exhibit 3.6 shows these projected earned rates of return on common equity for the years 1999 through 2004 under the "with asset transfer" and "no asset transfer" scenarios, using the high market price projections and the low market price projections. All other underlying assumptions, and the adjustments to the rate of return calculation I previously described, are the same for these calculations as those used in the base case.

15. Q. Since retail customer choice of generation services will commence in Illinois on October 1, 1999 and be available for all customers by May, 2002, have you prepared alternative financial projections under varying assumptions as to the amount of retail load which the Company may lose to alternative generation services suppliers?

A. No, we did not. The projected financial results are not thought to be sensitive to variations in the amount of retail load which remains with Illinois Power, for a number of reasons. First, if a retail customer switches to an alternative supplier, Illinois Power will receive transition charge revenues from the customer during the period covered by the financial projections. Second, the PPA contains a provision which allows IP to release capacity (thereby reducing the amount of capacity it is required to pay WESCO for). This provision can be exercised in the event that greater retail load loss than anticipated is experienced. In any event, the extent of retail load loss due to customer choice is not a function of whether or not the fossil generation assets remain with Illinois Power or are transferred to WESCO.

16. Q. Under Section 16-111(d), what is the test for determining if an electric

utility is eligible to request an increase in its base rates during the mandatory transition period?

A. The electric utility's two-year average of its earned rate of return on common equity, calculated in the manner I described in answer to Question no. 8, must be below the two-year average for the same two years of the monthly average yields of 30-year U.S. Treasury bonds, in order for the electric utility to be entitled to request an increase in its base rates.

17. Q. What was the average of the monthly average yields of 30-year U.S.Treasury Bonds for the 24 months ended December 31, 1998?

A. The average of the monthly average yields of the 30-year U.S. Treasury Bonds for the 24 months ended December 31, 1998, was 6.09%. This data is shown on IP Exhibit 3.7. For purposes of our financial projections, we have assumed that the yields on the 30-year U.S. Treasury Bonds remain at this level throughout the forecast period.

18. Q. What do you conclude from a comparison of the projected earned rates of return on common equity shown on IP Exhibits 3.2 and 3.6 and the two-year average of the monthly average yields of 30-year U.S. Treasury Bonds for the 24 months ended December 31, 1998 shown on IP Exhibit 3.7?

A. Unless the yields on 30-year U.S. Treasury Bonds increase dramatically from recent historical levels, Illinois Power's earned rates of return on common equity after the transfer of the fossil generation assets and the commencement of operations under the PPA with WESCO will be well above the levels to which the rate of return would have to fall in order for the Company to be entitled to request an increase in its base rates during the mandatory transition period. (In fact, the yield on the 30-year U.S. Treasury Bond at April 12, 1999, was 5.489%, considerably lower than the two-year average.) This conclusion applies under the base case market price forecast, the high market price scenario and the low market price scenario. Therefore, there is not a strong likelihood that Illinois Power will be entitled to request an increase in its base rates as a result of the transfer of its fossil generation assets. In fact, it is extremely unlikely that, with the asset transfer, Illinois Power would become eligible to request an increase in its base rates during the mandatory transition period.

III. PROJECTED FINANCIAL STATEMENTS

19. Q. Have you prepared projected financial statements for Illinois Power with the transfer of fossil generation assets to Illinova and without the transfer of assets?

A. Yes. These five-year financial projections are shown on IP Exhibits 3.3 and 3.4. IP Exhibit 3.3 contains the financial projections for the years 2000 through 2004 if the fossil generation assets are transferred to Illinova. IP Exhibit 3.4 contains the financial projections for the same years if the asset transfer does not occur. Page 1 of each exhibit shows the income statements, page 2 of each exhibit shows the balance sheets, and page 3 of each exhibit shows the statements of cash flows. Pages 4 through 8 of IP Exhibit 3.3 contain the statement of assumptions for the "with asset transfer" scenario. Pages 4 through 7 of IP Exhibit 3.4 contain the statement of assumptions for the "no asset transfer" scenario.

20. Q. Based on your financial projections, have you prepared a comparison of Illinois Power's key financial indicators for the forecast period if the fossil generation assets are transferred to WESCO and if the asset transfer does not occur?

A. Yes. This comparison is shown on IP Exhibit 3.8. The financial indicators shown are the rate of return on average common stock equity, the pre-tax interest coverage ratio, total debt as a percentage of total capital, the funds from operations interest coverage ratio, funds from operation as a percent of total debt, and net cash flow as a percentage of capital expenditures. The last five of these six ratios are used by Standard & Poor's Credit Rating Services in establishing senior debt ratings for electric utilities. IP Exhibit 3.8 also shows the actual values for each of these financial indicators for the 12 months ended December 31, 1998.

21. Q. Why are the values for the rate of return on average common equity shown on IP Exhibit 3.8 different from the values shown on IP Exhibit 3.2 for earned rate of return on common equity?

A. The rate of return on average common equity values shown on IP Exhibit 3.8 are based on a per-books calculation without the adjustments required by Section 16-111(d) of the Act.

22. Q. What do you conclude from these financial projections?

A. A comparison of Illinois Power's projected financial results with the transfer of the fossil generation assets to Illinova to the projected results without the transfer shows that Illinois Power's financial condition will be better if the fossil generation assets are transferred to Illinova than if they are not. Illinois Power's capital structure will be strengthened (i.e., debt as a percent of total capital is lower), and the other cash-based financial indicators will be better, if the fossil generation asset transfer is implemented than if it is not implemented. In addition, the Company's financial condition will be significantly improved over 1998 actual results.

23. Q. What are the principal reasons for the improved Illinois Power financial results with the transfer of the fossil generation assets to Illinova?

A. There are several reasons. First, Illinois Power will receive additional income through the interest that will be paid by Illinova on the note that is given to IP as consideration for the fossil generation asset transfer. Second, Illinois Power's depreciation, fuel, operation and maintenance and general tax expenses are reduced as a result of the transfer of the fossil generation assets to Illinova and the movement of the related operating activities to WESCO. This expense reduction is offset somewhat by the increased purchased power expense and reduced interchange revenues reflecting the payments to WESCO for capacity and energy under the PPA and the fact that IP will no longer have the resources to make significant interchange sales. (In the "no asset transfer" scenario it is assumed that IP realizes interchange revenues from the sale at market prices of capacity and energy that is freed up as retail customers switch to alternative power suppliers.) Third, IP is able to retire a significant amount of outstanding debt and preferred stock, thereby improving its capital structure and reducing its fixed charges, using the proceeds of the transaction including the partial paydown of the Illinova note, which I will describe in Section IV of this testimony. Fourth, Illinois Power's retail revenues remain the same in both the "with asset transfer" and "no asset transfer" scenarios, even though expenses are lower overall in the "with asset transfer" scenario.

IV. ASSUMPTIONS FOR FINANCIAL PROJECTIONS

24. Q. What is the purpose of this section of your testimony?

A. In this section of my testimony I will discuss the principal assumptions that were used in preparing the financial projections. As I have noted, the statements of assumptions are shown on pages 4 though 8 of IP Exhibit 3.3 and on pages 4 through 7 of IP Exhibit 3.4. In addition, I have already described the source of the values used for the market prices of electric power and energy.

25. Q. What is shown on IP Exhibit 3.9?

A. IP Exhibit 3.9 is the listing of the assets and related liabilities which will be transferred from IP to Illinova. The total net costs of these assets (i.e., the assets less the related liabilities being transferred) on IP's books at December 31, 1998 was $2.698 billion. The financial projections in the "with asset transfer" scenario assume that these assets and related liabilities are transferred to Illinova and are removed from IP's books. In addition, a note receivable with an initial principal balance of $2.698 billion, which is the consideration for the asset sale, is recorded as an asset on Illinois Power's balance sheet. When the asset transfer actually occurs, the current values at that time will be used.

26. Q. Does the asset transfer listing on IP Exhibit 3.9 include the Tilton combustion turbines ("CT Units"), the selective catalytic reduction ("SCR") facilities at Baldwin Power Station, and the facilities being installed at Baldwin and Hennepin Power Stations to permit Powder River Basin coal to be burned ("PRB"), which were the subject of the Company's Section 16-111(g) notice to the Commission on March 31, 1999 that these assets will be transferred to a special purpose entity in order to implement an off-balance sheet financing?

A. Yes. However, as stated in the Company's April 16, 1999 notice, if the off-balance sheet financing has been closed prior to the date of the transfer of the fossil generation assets to Illinova, then Illinois Power's leasehold rights to the CT Units and the SCR and PRB facilities will be transferred to

WESCO. The financial projections I am presenting assume that the off-balance sheet financing of these assets has been completed. In the "no asset transfer" scenario, the lease payments are included in IP's operation and maintenance expense. In the "with asset transfer" scenario, Illinois Power's rights under the leases and the related obligation to make lease payments are assumed to be transferred to WESCO.

27. Q. How were the peak demand and energy sales projections used in the financial projections developed?

A. The peak demand and energy projections are the same employed in the "Base Forecast" used in the reliability analysis presented by Mr. Eimer and Mr. Reynolds.

28. Q. How was the use of the PPA to supply energy to Illinois modeled for purposes of the financial projections?

A. It was assumed that all of the Company's energy requirements through December 31, 2004, exclusive of those supplied from CPS and from other sources available to the Company (e.g., from Electric Energy, Inc.), are obtained from WESCO as Tier 1 Energy under the PPA. For each year, Illinois Power's projected annual kwh sales, less energy available from CPS and from third-party sources, are less than the annual Tier 1 Energy entitlement under the PPA.

29. Q. What assumptions were used with respect to the operation of CPS?

A. It was assumed that CPS returns to operation in May 1999, operates through August 1999, and is then permanently shut down. Decommissioning is assumed to commence immediately after shutdown, using the immediate dismantlement (DECON) method.

30. Q. How were the interest rate and annual interest payments on the note payable from Illinova to Illinois Power developed?

A. The note will have a ten-year maturity with a fixed interest rate of 7.0% per year on the unpaid principal balance. This interest rate was developed based on the yield of the ten-year U.S. Treasury Bond due May 2009 at the close on April 12, 1999, as reported in the Wall Street Journal, April 13, 1999 (5.24%) plus 175 basis points, which was rounded to 7.0%. The 175 basis point adder is representative of the recent spreads between yields on BBB-rated corporate debt and yields on ten-year U.S. Treasury Bonds. Illinova is projected to pay down the balance of the note by $800 million at the closing of the fossil generation asset transfer, or shortly thereafter, using the proceeds of a refinancing of the WESCO assets. After this initial paydown, the unpaid principal balance is $1.9 billion. The remainder of the principal repayment does not occur until the maturity of the note, which occurs after the forecast period.

31. Q. What assumptions were used with respect to property taxes on the fossil generation plants?

A. The statements of assumptions contained in IP Exhibits 3.3 and 3.4 show the annual property tax expense for the fossil units. These amounts are the same in both scenarios; however, in the "with asset transfer" scenario the property taxes are paid by WESCO whereas in the "no asset transfer" scenario the property taxes are paid by Illinois Power. In both scenarios, property taxes on the fossil generating plants are set to be consistent with the recent proposal of the Electric Property Tax Assessment Task Force established by House Bill 1817, which was enacted at the same time as the Electric Service Customer Choice and Rate Relief Law of 1997.

32. Q. What do the financial projections for the "with asset transfer" scenario incorporate as the uses of the $800 million payment which Illinois Power receives from Illinova as the initial principal repayment on the note?

A. A total of $508 million of this amount is used to repurchase or retire outstanding debt in the year 2000. An additional $100 million is used to retire outstanding preferred stock in 2001. The remaining $192 million is used for internal financing purposes and avoids the need for new external financing. In the "no asset transfer" scenario, Illinois Power is assumed to issue an additional $195 million of debt which is not required in the "with asset transfer" scenario. The need to issue additional debt in the "no asset transfer" scenario is due to (i) the absence of the payment on the note from Illinova and (ii) the lower level of free cash flow in the "no asset transfer" scenario.

33. Q. Does this conclude your prepared direct testimony?

A. Yes, it does.